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The Political Economy of SME Development Policy in Indonesia -- the Policy Process, the Facts, and Future Possibilities

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The Political Economy of SME Development Policy in Indonesia -- the Policy Process, the Facts, and Future Possibilities

The Policy Process -- Consensus and Dissensus

The SME development policy process in Indonesia is ostensibly the same as in many other countries -- with a consensus that hides a dissensus. There are competing intellectual approaches, parties, interest groups and institutions. The naïve often ask where are the small businessmen themselves, but precisely because they are scattered, they only count to the extent that they find, usually competing, institutional expression.

The different organized groups of small businessmen, in fact, typically reflect conflicting interests and ideas. KADIN (Kamar Dagang dan Industri) is seen as representing larger, better connected "pribumi" interests. The new FORDA (Forum Daerah) that have sprung up represent younger and less well connected small businessmen. PUPUK (Perkumpulan Untuk Peningkatan Usaha Kecil) represents still smaller businessmen. Chinese small businessmen have yet other political expressions. In fact, a number of political and religious groups, particularly Nahdat Ulema and Muhammadiyah serve as channels for significant groups of small businessmen to express themselves. The competing intellectual positions are usually characterized in Indonesia as between "technocrats," nationalists, and populists but all overlap and each individual advocate is compromised by its own special interests.

The technocrats support small business because SME promotion is seen as a cheap concession to opponents, as well as a way to promote social equity -- a means that is endorsed by all sides. But, at least in Indonesia, technocrats are committed to markets and lean if effective government. Further, they have traditionally been closely allied with the donors and the Washington consensus, and this identity has been increased by what the technocrats see as wanton irresponsibility by the other groups during the Monetary Crisis.

For nationalists and populists, small business is often a code word for the "pribumi," ethnic Indonesian entrepreneurs, they wish to enfranchise. In some cases, interest in SME development reflects a focus on the rising small and medium scale entrepreneurs, in other cases the poor and self employed. The former cases are especially concerned with production and social power, the latter with social justice and poverty alleviation.

Technocrats, nationalists and populists are spread across all political parties, so it is difficult to map their position into the cross-cutting Islamic, Secular Nationalist, and what might be described as Bureaucratic political traditions in Indonesia -- but as we will see at least the Islamic element is certainly a salient one. This is because Islamic approaches, and especially Islamic finance, are seen not only as in conformity with Islam, but also as efficacious means to empower both pribumis and the poor. Other Islamicists are not partisans of specifically Islamic financial institutions. The present president has as much as said that he views Shariah/Islamic financial institutions as an additional handicap for Muslim pribumis.

The Old Paradigm, Its Critics, and the New Paradigm

All of these different intellectual approaches, however, converged in their assent to the "Old Paradigm" of small business promotion which had its origin in US inspired schemes in the

1950s and 1960s and involved providing an integrated package of technical assistance, marketing, and financial assistance at subsidized rates, and often protected markets to some targeted small businessmen and farmers.

This "Old Paradigm" has since been subjected to a withering critique both in Indonesia and elsewhere on the grounds that it used a lot of money to little effect. Much of whatever resources were provided were captured as rents by interested politicians and bureaucrats. The enterprises assisted were inefficient and uncompetitive. Further, as a result of subsidization, financial and technical assistance institutions were undermined and efficient small businesses subjected to unfair, unsubsidized competition.²

At the end of the day, the banks which served SME were in ruins, the technical assistance organizations unpatronized, and many of the assisted SME closed. The empirical data vary from country to country but they generally bear out this pattern and certainly do so in Indonesia.

Meanwhile, a number of financing schemes for microenterprise had been able to demonstrate a much lower level of costs and positive outputs. The most recent summary of the literature concludes that the very smallest loans (of under \$150-\$250) probably require some subsidy, and that the very poorest borrowers experience a smoothing of their income stream rather than an increase in income.³ But unsubsidized schemes for the middle of the income distribution (like BRI's world famous Unit Desa) do seem to increase relative incomes of borrowers on a non-subsidized basis. If the poorest of the poor are not benefited, the poor majority, the vast middle of the income spread are.

As a result of disenchantment with the "Old Paradigm," there emerged a "New Paradigm" in which finance and services were to be provided at market rates or with very shallow and broadly based subsidy. The new paradigm concentrated on subsidizing the start up costs of eventually self-sustaining institutions, rather than on income subsidies to their clients. This new paradigm was introduced based on the contention that access was more important than price. Subsidies had to be specifically justified to meet identified market failures. It should be noted that the new paradigm based itself on the economists' comparative static cost benefit approach -- rather than politicians insights which are often more concerned with symbolic impacts and the strategic, and effective, use of patronage.⁴ As should be clear as well, the thrust was one which emphasized financing above other inputs, having determined that finance was very important, at least as an object of public policy. This focus may be justified by the high level of regulation to which financial services are subject because of prudential concerns.

² David C. Cole and Betty F. Slade, *Building a Modern Financial System: The Indonesian Experience*, Cambridge, UK: Cambridge University Press, 1996. Anwar Nasution, *Financial Institutions and Policies in Indonesia*, Singapore: Institute of Southeast Asian Studies, 1983, pp. 101-107. Dale W. Adams, Douglas H. Graham, and J. D. von Pischke, *Undermining Rural Development with Cheap Credit*, Boulder, Colorado: Westview Press, 1984. Donald Snodgrass and Tyler Biggs, *Industrialization and the Small Firm: Patterns and Policies*, San Francisco, Ca.: ICEG, 1996.

³ Jonathan Morduch, "The Microfinance Promise," **Journal of Economic Literature** XXXVII, 4, December 1999, pp. 1569-1614

⁴ Thomas A. Timberg, "Small Enterprise Promotion in India," *Small Enterprise Development* I, March 1990, pp. 26-31.

No one questions that to the extent to which industrial technology is a factor in SME growth it requires some government coordination and perhaps subsidy of research and extension; or that the social externalities from training for SME justify some subsidy there as well, but finance was granted primacy.

The thrust for small scale credit reform in specific -- agricultural and non-agricultural -- coincided with a general zeitgeist favoring financial liberalization and a disenchantment with industrial policy, but its motivation and dynamic are separate. Only at the very top of the SME size hierarchy might there be direct overlap in the argument presented. The general arguments for industrial policy do not concern special approaches to SME and related financial sector interventions.⁵

Actually, and naturally, the discussion was much influenced by a parallel discussion of agricultural policy -- in agriculture the importance of technical inputs (research, extension, and even improved inputs) was generally granted, as well as the existence of inherent market failures in supplying them to farmers. The arguments on agricultural credit were applied by analogy to SME credit, but as I indicated above the focus on finance was less since a public role in agricultural research and extension were more generally accepted.

An analogous role for small industrial extension might be made, but the variety of technologies involved make that a harder case to make. Nonetheless, no one who has been around the world can avoid cases in where whole sectors were created by specific technical interventions. The case for the value of general financial management, marketing, and commercial technical assistance to SME as especially valuable to SME can also be made, and has been supported by some evaluation work in Latin America, but I am not familiar with such a literature in Asia.

Almost all the participants in the Indonesian SME policy process have ostensibly bought into the "New Paradigm," and had done so before the Monetary Crisis, which dramatically increased the influence of donors and the necessity of placating them. This as noted above was motivated by the perceived failure of the "Old Paradigm." But, as usual, "the devil is in the details," -- just what sort of market prices are applicable (what are market prices in some cases, as for example, for bank credit with largely publicly owned banks), where are subsidies justified, and worse who should handle them. Meanwhile, the discourse in the media is still dominated by a focus on the provision of directed credit and services at subsidized rates or free. Much of this discourse refers to promises because the overall limitation in public resources often mean that they are not available. Exactly, to what extent these announcements or the flow of funds or services that they imply serve symbolic or patronage purposes is unclear. In fact, the public skepticism about them suggests to me, that they are simply being resorted to as a familiar routine by all concerned in a time of turbulence and uncertainty.

The fact is that there are no resources for the Old Paradigm, as well as little high-level policy support. On the other hand, the initiatives for New Paradigm initiatives -- institutional subsidization, thin subsidies etc. seems largely absent.

⁵ Thomas A. Timberg, "Two Discourses: Financial Liberalization Happened," *Economic and Political Weekly*, November 8, 1997.

The Institutional Players

Institutionally, most players in the Indonesian enterprise promotion system have their own systems of finance and promotion that they wish to advance. The Family Planning Board (BKKBN) has a small loan program for poor women -- TAKESRA/KUKESRA. The social welfare program, the cooperatives, the banks, the Ministries of Interior, Agriculture, Trade and Industry, and Labor all have had schemes of their own at some point. Some of these programs are self-contained and some use banks and cooperatives as instruments. The goals (social and productive), the schemes (market or subsidized), the beneficiaries (big or small) and the records (sustainable or corrupt), and the targets (in terms of industry, region etc.) all differ considerably.

All of the players are all in continuous competition for budget resources (for subsidies), bank funds (on market or other bases), and for publicity and clients. A few agencies (Bank Indonesia, BAPPENAS, the competitive donors) have tried to coordinate all the players, but since there is no advantage to the competitors in coordination (even to the various competing donors) this coordination has not been successful. Nor is it clear that coordination is ultimately desirable since competition among programs is likely to result in something like the survival of the fittest (as the unfit dissipate their funds and political support), at least as long as the standard of sustainability prevails and some level of transparency is achieved in the competitive process.

I once suggested that all governments should have two SME support institutions -- a good one aiming at broad based, sustainable impact, and a bad one as a lightening rod to use for symbolic and patronage funds.

Among the prime competitors in financing SME are PT Madani (PNM) and Bank Rakyat Indonesia (BRI). The former is a newly created public sector company with a variety of programs involving venture capital, entrepreneurship promotion, and funds management, all of which are largely unfunded, except for a large fund of directed public credit lines that it administers. The nominal value of the initial funds transferred was 10 Trillion Rps (1-2 billion dollars) but these include large outstanding loans which may be hard to collect. The terms and conditions of the loans appear highly constrained by government policy and PNM appears to be moving slowly and carefully in making new loans.

BRI is a vast public sector bank that has two large subunits (Unit Mikro, Unit Retail) doing relatively small scale lending through a nationwide set of branches. It experienced considerable losses in its larger scale lending, required recapitalization with the rest of the banking system, and is now committed under new management to re-center its business on smaller scale borrowers. Its Unit Mikro business has been expanding and is highly profitable. Unit Retail had considerable arrearages, but a steady source of income in lending to civil servants against their salaries and is now trying to reorganize and expand its business. In addition, BRI has been given responsibility for directed government lending to agriculture and is moving to extend its agricultural lending role. It presently accounts for more than half of legally defined SME lending.

As is noted elsewhere, these two organizations account for a good portion of present SME lending -- almost certainly more than half, and their institutional future is thus key. New lenders can and should emerge and these have been the focus of considerable discussion.

They include private and public sector banks (including the rural banks), finance companies, and guarantee funds.

Another group of players are the donors, who are also nominally committed to the new paradigm, but also support various favorite initiatives of their own. Each occasionally advances and is expected to advance models based on its own experience at home and elsewhere. Thus, Self Help Groups have become a German specialty, guarantee agencies are especially pushed by the Japanese (though the Europeans like mutual guarantees, and everyone has their favorite guarantee approach), the Americans are especially concerned with having private sector executing agencies -- though not in Indonesia where BRI, a big public sector bank, itself is often supported by them.

The donors typically converge in the complex web of cross-conditionality which affirms their consensus with the government, and often diverge because they are pursuing their negotiations with the government on separate tracks. At the moment the Europeans, the multinationals, and the U.S. especially converge on the new paradigm, while the East Asians have more sympathy with the old one. The East Asians point out that it is the old paradigm which characterizes most SME promotion programs in the home countries of the donors.⁶

One of the key questions is how several impending changes -- decentralization to the provincial or lower levels, the ceasing of some of the funding roles of the central bank, and changes in bank supervision will effect SME development.

The "new boy on the block" is clearly the parliament or elected politicians in general, and the newly active non-government sector. Many of these "new boys" are clearly interested in SME policy, but there still does not exist much in the way of institutional channels in which they can express themselves.

Another category of important contenders is now the provincial governments, which have their own development banks and connected chains of local financial institutions as well as directing to various extents SME extension and training operations. Outside of Jakarta, SME lending often accounts for high proportions of SME lending, See Table I below.

Another of the key elements will be the shift of the focus of power to the local level, where the "new paradigm" is less accepted, but resources for the "old paradigm" more limited than at the center. The local participants, however, mirror those at the center, so we should soon have 26 provincial policy subsystems at work.

The biggest of the "new boys" is the president himself, Gus Dur, who has a long-term interest in SME policy, and has made SME a key element in the social program he advocates. On the other hand, his resources are limited, and he has, as well a long-term skepticism about central government programs as a whole. He has advocated bottom up community self-help. Thus far his involvement has mostly been symbolic -- launching a national microfinance movement, but not necessarily pouring Indonesian money into following their suggestions.

⁶ The background here is complex. The generalization might be that the analysts and economists who back the new paradigm at home, have to contend with interest groups and politicians who oppose it. The point at which the balance is struck varies, but typically most SME have little to do with the explicit government promotion programs -- though the proportion is often higher than in Indonesia.

Products of the SME policy system are still emerging, but is likely, as in other fields, to produce more continuity than otherwise. On the level of regulation, more democratic politics will block regulations such as those which handed the clove trade to a Suharto family member, but maybe strengthen efforts by each province's businessmen to keep out their competitors. Decentralization will make politicians more responsive to some local interests, but maybe increase their desire to extract revenue from SME.

On the level of finance and technical assistance for SME, continued constrained government finance probably means more will be done on a commercial basis. One hopes regulation of financial institutions helps rather than hinders this process.

What To Do

As many have perceived, a common accounting matrix, perhaps that proposed by Yaron at the World Bank and adequate accounting are the most powerful forces in structuring the competition of programs and this competition in turn is in the interest of competitors because in its absence, they cannot compete effectively for outside funds.⁷

In a recent talk in Jakarta, Jonathan Morduch, clearly stated the conditions for government pro SME interventions that make sense -- clarity of goal, efficiency of execution, and transparency of reporting.⁸

⁷ Jacob Yaron, "Assessing Development Finance Institutions," World Bank Discussion Paper No. 174, Washington, D.C., 1992.

⁸ Jonathan Morduch, Talk at Bank Indonesia, Jakarta, August 8, 2000.